



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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State Controller

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Executive Director

January 15, 2009

Dear Interested Party:

Enclosed is the Discussion Paper on proposed new [Regulation 1698.5, Audit Procedures](#). Discussion regarding proposed Regulation 1698.5 is scheduled for the Board's **May 27, 2009 Business Taxes Committee** meeting.

Before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, meetings are scheduled at the following Board of Equalization offices:

Chicago: February 3, 2009 at 10:00 A.M., CST
120 N. LaSalle Street, Suite 1600
Chicago, Illinois

New York: February 5, 2009 at 10:00 A.M., EST
485 Lexington Avenue
New York, New York

Sacramento: February 10, 2009 at 10:00 A.M., PST
450 N Street
Sacramento, California.

If you are unable to attend a meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the letterhead address or send a fax to (916) 322-4530 before the meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting.

If you plan to attend any of the meetings, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Ms. Lynn Whitaker at (916) 324-8483 or by e-mail at Lynn.Whitaker@boe.ca.gov a week prior to the meeting date. This is especially important for those attending the New York meeting as it will significantly streamline the building security procedures. In addition, please let Ms. Whitaker know if you wish to have future correspondence, including the issue paper and all attachments, sent to your e-mail address rather than to your mailing address.

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Whether or not you are able to attend one of the above interested parties' meetings, please keep in mind that the due date for interested parties to provide written responses to staff's paper is **March 6, 2009**. Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

Thank you for your consideration and I look forward to your comments and suggestions.

Sincerely,

Jeffrey L. McGuire
Chief, Tax Policy Division
Sales and Use Tax Department

JLM:llw

Enclosures

cc: (all with enclosures)

Honorable Judy Chu, Ph.D., Chair, Fourth District
Honorable Betty T. Yee, Vice Chairwoman, First District (MIC 71)
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Michelle Steel, Member, Third District
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel
Mr. Steve Shea, Board Member's Office, Fourth District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Sabina Crocette, Board Member's Office, First District
Mr. Gary Qualset, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Ken Maddox, Board Member's Office, Third District
Mr. Neil Shah, Board Member's Office, Third District
Ms. Elizabeth Maeng, Board Member's Office, Third District
Ms. Christina Rueck, Board Member's Office, Third District
Ms. NaTasha Ralston Ratcliff, State Controller's Office
Mr. Ramon J. Hirsig
Ms. Kristine Cazadd
Ms. Randie L. Henry
Mr. Jeff Vest
Mr. David Levine
Mr. Randy Ferris
Mr. Tim Treichelt
Mr. Robert Tucker
Mr. Andrew Kwee
Mr. Todd Gilman
Ms. Laureen Simpson
Mr. Robert Ingenito Jr.

Mr. Bill Benson
Ms. Freda Orendt
Mr. Stephen Rudd
Mr. Kevin Hanks
Mr. James Kuhl
Mr. Geoffrey E. Lyle
Ms. Leila Hellmuth
Ms. Lynn Whitaker
Ms. Lynda Cardwell

DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

Issue

Should a new regulation be adopted that would outline general audit procedures and include the expectation that sales and use tax audits be resolved within a two-year period?

Background

The objective of a sales and use tax audit is to determine, with the least possible expenditure of time, that taxes have been correctly reported. To accomplish this objective, the Sales and Use Tax Department Audit Manual provides detailed procedures and techniques for verifying amounts reported on sales and use tax returns. Currently, the Board of Equalization (Board) does not have a regulation describing general audit procedures. Staff believes providing a high level description of these in a regulation will promote commitment and accountability between staff and the taxpayer, and will result in the more timely completion of audits. To further meet this goal, staff proposes including in the proposed regulation the expectation that audits be resolved within a two-year period.

In general, the audit of a taxpayer's books and records must be completed in sufficient time to permit the issuance of a notice of deficiency or overpayment within the applicable statute of limitations. To be timely, every notice of deficiency determination must be mailed within three years after the last day of the calendar month following the quarterly period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires later; unless the taxpayer has consented in writing to extend the time period or a longer period of issuance of a Notice of Determination is provided under the Sales and Use Tax Law. Audit staff will request the taxpayer sign a Waiver of Limitation when the taxpayer requests a postponement while an audit is in process, or when there has been excessive taxpayer delay before an audit begins.

In recent years, the Board has noticed a definite trend by taxpayers and their representatives to delay starting and/or completing audits, or avoiding or delaying providing information requested for an examination or audit engagement. Some audits have gone unresolved for years; some with hundreds of audit hours spent in attempting to secure the requested books and records. To see if they encountered similar issues and how those issues were addressed, Board staff contacted staff from the California Franchise Tax Board (FTB).

The FTB also experienced similar problems with aged audits in the past. To improve their audit procedures, FTB met with interested parties, developed a Best Audit Practices guide, and incorporated their general audit procedures into Regulation 19032, *Audit Procedures*. Subdivision (a)(2) of this regulation provides in part:

“... To facilitate the timely and efficient completion of an audit within the above-referenced statutory timeframes, the taxpayer should have the expectation that the audit of the tax return would be conducted in a manner so that the resolution of the audit will be achieved within a two-year period commencing with the date of the “initial audit contact” as subsequently defined. ...”

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With the adoption of this regulation, FTB switched to a two-year audit period and approximately 90% of their audit cases are now completed within the two-year time-frame. FTB still maintains the discretion to secure a waiver of limitation if any period within the audit is subject to expiration; however, it is rare that they do so. Although Board staff is not proposing to switch to a two-year audit period, by adopting the expectation that Board of Equalization audits will be completed within two years, staff may reach its goal of significantly reducing the number of aged audits in process more than 24 months.

Proposed Changes

Staff recommends that the Board adopt a regulation on audit procedures that conforms to the FTB regulation. The regulation would broadly describe general audit procedures and include the expectation that Sales and Use Tax Department audits be completed in two years from the start of the audit. (See Exhibit 1.)

Completion of audits in two years. While most Board audits are completed within a few months, some audits, particularly those where the records are located outside California, take longer. For field audits, the “initial audit contact” will be defined as the first meeting between the taxpayer and/or taxpayer’s representative and the Board’s audit staff. “Initial audit contact” will not include a pre-audit conference with a Board representative to discuss the availability of records, including electronic records¹.

Staff believes this proposal will facilitate the Board’s timely and efficient resolution of audits. The proposal will also provide taxpayers with the expectation that the audit of their tax records will be conducted in a manner so that resolution of the audit will be achieved within a two-year period. The two-year period is intended to provide for the orderly and timely progression of an audit that will lead to a quick conclusion and would not be used to limit a taxpayer’s right to provide information in support of the tax return as filed or amended. The two-year period would end when the audit report is completed.

Although it is expected audits will be completed within the two-year timeframe, there may be rare situations where the audit will take longer. It is the auditor’s responsibility to ensure a waiver of limitations is obtained before the statute of limitations expires. The proposed regulation also explains situations - such as cases of fraud or bankruptcy - when the two-year timeframe will not apply. [See subdivision (a)(2).]

Other proposed policy changes. In addition to the two-year completion timeframe, the Board proposes other changes to current policies:

¹ Board of Equalization representatives include the Board’s Computer Audit Specialists. In response to the growing need to audit through sophisticated taxpayer computer systems, the Sales and Use Tax Department developed a Computer Audit Specialist program. The goal of the program is to provide technical support to auditors who conduct reviews of complex electronic accounting systems. Often, Computer Audit Specialists meet with taxpayers prior to the start of an audit to review and understand the taxpayer’s computerized accounting system.

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- The Board will not hold in abeyance the start of a subsequent audit pending the conclusion of a current or prior audit [subdivision (b)(5)].
- At the opening conference, the auditor will provide a written document stating the name and phone number of the audit supervisor and any designated Computer Audit Specialist assigned to the audit [subdivision (b)(6)(A)].
- The audit plan (audit program) prepared at the beginning of the audit will be discussed with and provided to the taxpayer or taxpayer's representative at the opening conference. The audit plan should be signed by both the auditor and the taxpayer or taxpayer's representative to show a commitment by both parties that the audit will be conducted in the manner discussed to allow for the completion of the audit within two years. [Subdivision (b)(6)(B)].
- As a general rule, the taxpayer will have a maximum of 30 days to respond to a written Information/Document Request (IDR). However, the auditor may allow additional time if the auditor believes it is warranted. [Subdivision (b)(6)(C)].

Proposed 25% Penalty for Not Providing Records

As part of conforming to FTB's successful audit practices and procedures, at the November 12, 2008 meeting of the Board's Legislative Committee, the Board approved sponsoring legislation to amend Revenue and Taxation Code section 7054 to authorize the Board to impose a 25% penalty when a taxpayer fails or refuses to timely or completely furnish any information, documents, or books and records (including electronic records) requested in writing by the Board during an examination or audit engagement, unless the failure is due to reasonable cause and is not due to willful neglect. Currently, the Board is seeking an author for the bill. If the proposed legislation is enacted, the provisions will be incorporated into proposed Regulation 1698.5.

Summary

Staff proposes adding Regulation 1698.5 to outline general audit procedures, including the expectation that Sales and Use Tax Department audits be completed in two years from the initial audit contact. The proposal is intended to foster cooperation between staff and taxpayers and to encourage the timely completion of audits. The scope of this issue is limited to the general procedures provided in the proposed regulation; other policies and procedures provided in the Board's Audit Manual are not scheduled for discussion. Staff welcomes any comments, suggestions, and input from interested parties regarding this issue.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 1/15/2009

Regulation 1698.5. AUDIT PROCEDURES

Reference: Sections 7053 and 7054

(a) General.

(1) The purpose of an examination or audit is to efficiently determine the correct amount of tax based on an analysis of relevant tax statutes, regulations, and case law as applied to the facts of the examination or audit.

(2) In general, the examination or audit of a taxpayer's records must be completed in sufficient time to permit the issuance of a notice of deficiency assessment or overpayment within the applicable statute of limitations. Consequently, examinations or audits must be completed prior to the expiration of the statute of limitations unless the taxpayer consents to extend the period by signing a waiver of limitation. To facilitate the timely and efficient completion of an audit within statutory timeframes, the taxpayer should have the expectation that the audit of the tax returns would be conducted in a manner so that resolution of the audit will be achieved within a two-year period commencing with the date of "initial audit contact" as subsequently defined. This two-year guideline will not apply in the following circumstances:

(A) The audit investigates the recommendation of the imposition of a penalty for fraud or intent to evade the tax, knowingly operating without a permit, or knowingly collecting sales tax reimbursement or use tax by a person who fails to remit the sales tax reimbursement or use tax to the Board.

(B) Audits that are delayed as a result of the taxpayer's bankruptcy proceedings.

(C) Audits involving proceedings concerning the enforcement or validity of a subpoena or subpoena duces tecum.

(3) Taxpayer's Duty to Respond. A taxpayer, or the taxpayer's representative, has the duty to make a timely response to requests for information or documents by the Board of Equalization that are relevant and reasonable, or provide an explanation as to why additional time is necessary to respond or state why the request is not relevant or reasonable.

The auditor and the taxpayer or the taxpayer's representative should work together to make information requests relevant and reasonable including the use of alternative sources of information in order to substantiate the facts and circumstances of the issue under audit. For example, the auditor and the taxpayer or the taxpayer's representative may agree to a procedure in which the auditor would draft an information request, discuss the information request with the taxpayer or the taxpayer's representative, and the auditor would take into account such comments before issuing the formal information request.

(4) Duty of Board of Equalization Staff. Board of Equalization staff has the duty to:

(A) apply and administer the Sales and Use Tax Law in a reasonable, practical manner consistent with applicable law,

(B) take into account the materiality of an issue being audited as defined in subsection (a)(7) of this regulation,

(C) make relevant and reasonable information requests for the issues under examination:

1. The auditor shall explain the relevance or reasonableness of the request when asked to do so,

2. Requests for information are relevant if the requested information is germane to or applicable to the audit issue, and

3. The auditor and the taxpayer or the taxpayer's representative should work together to make information requests relevant and reasonable including the use of alternative sources of information in order to substantiate the facts and circumstances of the issue under audit.

(D) timely analyze information received or responses submitted and to request additional relevant information or inform the taxpayer of the potential audit determination.

(E) apply the relevant statutes and regulations in a consistent manner regardless of whether the determination of the correct amount of tax results in an assessment or overpayment.

(5) Duty to Maintain Records. Generally, it is the taxpayer who will be in possession or control of the necessary information, documents, books and records and who will have the knowledge regarding the circumstances of the relevant activities such that a determination of the correct tax can be made. The inability, or failure, of a taxpayer to supply requested relevant information in support of the tax returns as filed may result in a Notice of Determination being issued. A taxpayer has a duty to maintain relevant records and documents pursuant to normal accounting or regulatory rules and the rules set forth in the California Revenue and Taxation Code. The Board of Equalization recognizes that taxpayers are sometimes not able to respond to each and every request for data. The auditor should work with the taxpayer to resolve difficult information requests or any other problems in generating information request responses.

(6) Application of Time Limits. The guidelines of this regulation are intended to provide for an orderly process that leads to a quick conclusion to the audit and are not to be used to foreclose or limit a taxpayer's right to provide information in support of the tax returns as filed or amended.

(A) The Board of Equalization recognizes that some Information/Document Requests and Audit Issue Presentation Sheets can be responded to in less than 30 days while other responses will require time in excess of 30 days. (See subsection (b)(6) of this regulation for definitions of referenced documents.) The auditor has discretion to take into account the taxpayer's facts and circumstances in establishing the original response time or to allow extensions of time to respond.

(B) The auditor shall take into account responses to Information/Document Requests and Audit Issue Presentation Sheets received after the established date for a response, provided the audit period will not expire due to the statute of limitations.

(C) The guidelines identified in this regulation do not supersede or have any bearing on the statute of limitations for issuing deficiencies or refunds as provided by the Revenue and Taxation Code. Failure to adhere to the guidelines of the regulation will have no effect on the validity of a notice of determination, offset, notice of refund, or no change audit issued within the applicable statute of limitations period, or on any rights of the taxpayer.

(7) Materiality. Audit issues are based on the materiality of the potential adjustment and balanced with the statutory requirement to determine the correct amount of tax. If potential for an audit adjustment is likely, the issue should be pursued if the materiality of the potential adjustment warrants the audit resources necessary to audit the issue. Auditors will use judgment as to what constitutes materiality for purposes of this subsection as materiality is a facts and circumstances test. The auditor will discuss materiality at any time during the audit if so requested.

(b) Audits.

(1) Definition of "Initial Audit Contact". "Initial audit contact" as used in subdivision (a)(2) of this regulation is defined as the date of the first meeting between the taxpayer and/or the taxpayer's representative and the Board of Equalization audit staff. "Initial audit contact" does not include a pre-audit conference with a Board of Equalization representative(s) to discuss the availability of records, including electronic records. Generally, the Board of Equalization staff should first contact the taxpayer within three years of the date on which the tax return is filed.

(2) Location of Audit. An audit will generally take place at the location where the taxpayer's original books, records, and source documents pertinent to the audit are maintained. This will usually be the taxpayer's principal place of business. Audits can be moved to a Board of Equalization office, or the taxpayer's representative's office, if the taxpayer (or the taxpayer's representative) does not have the appropriate work area available or the taxpayer or the taxpayer's representative does not have time available for the audit to be conducted at their location, or as circumstances of the taxpayer warrant.

(3) Site Visitations. Regardless of where the audit takes place, Board of Equalization staff may visit the taxpayer's place of business to gain a better understanding of the business' operations. Board of Equalization staff generally will visit for these purposes on a normal workday of the Board of Equalization during the Board's normal business hours.

(4) Requests by Taxpayers to Change the Place of Audit. The Board of Equalization staff will consider, on a case-by-case basis, requests by taxpayers or their representatives to change the place that the Board of Equalization has set for an audit. Reasonable requests to move an audit to another of the taxpayer's offices or to the taxpayer's representative's office will be granted unless doing so would impose an unreasonable burden to the Board of Equalization staff or significantly delay the completion of the audit.

If the taxpayer requests that the audit be conducted at a Board of Equalization office, or the taxpayer's representative's office, it is the taxpayer's responsibility to deliver all requested books and records necessary for the audit to the agreed location.

(5) Time of the Audit. It is reasonable for the Board of Equalization to schedule the day or days of the audit during a normally scheduled workday or workdays of the Board of Equalization, during the Board's normal business hours. It is reasonable for the Board of Equalization to schedule audits throughout the year, without regard to seasonal fluctuations in the businesses of particular taxpayers or their representatives. However, the Board of Equalization will work with taxpayers or their representatives to try to minimize any adverse effects in scheduling the date and time of the audit.

The Board of Equalization will not hold in abeyance the start of an audit pending the conclusion of an audit for prior periods.

(6) The following audit procedures may be used depending on the nature of the audit.

(A) Opening Conferences. Items to be discussed during the opening conference include, but are not limited to, the audit plan, estimated timeframes to complete the audit, the scheduling of future audit appointments, discussion of the scope of the audit, the taxpayer's record retention policy, any corrections to information reported on the return that the taxpayer has identified and wants the auditor to take into account, possible claims for refund, information requests, and photocopying.

At the opening conference, the auditor shall provide a written document stating the name and phone number of the audit supervisor and any designated Computer Audit Specialist assigned to the audit.

(B) Audit Plan. A written audit plan is required for all audit assignments. The audit plan documents key dates and issues related to conducting the examination. A copy of the audit plan should be discussed with and provided to the taxpayer or taxpayer's representative at the opening conference or shortly thereafter. The audit plan should be signed by the auditor and either the taxpayer or the taxpayer's representative to show a commitment by both parties that the audit will be conducted in the manner discussed to allow for the completion of the audit within two years. The audit plan is considered a guideline for conducting the examination and can be amended throughout the audit process as circumstances warrant.

(C) Information Document/Request (IDR). The Board of Equalization may provide a taxpayer an Information Document/Request (IDR) requesting single or multiple documents. Verbal requests for information that are not responded to as required by the auditor should be requested through the IDR process. As a general rule, response times for information requests shall be determined on a case-by-case basis with a maximum response time of 30 days from the date a IDR is hand-delivered to the taxpayer, or the taxpayer's representative by the auditor or the date mailed by the auditor or as otherwise provided for in subsection (a)(6)(A) of this regulation.

1. As a general rule, where a reply by the auditor is appropriate or the auditor needs additional information, the auditor will notify the taxpayer or the taxpayer's representative within 30 days of the auditor's receiving the response to the IDR or Audit Issue Presentation Sheet. Notification is achieved by a response indicating additional time is necessary to respond and providing a date for future contact.

2. Failure to provide a timely and complete response to a request from the Board of Equalization for additional information may result in the audit being determined by resolving questions of fact to which the requests relate against the taxpayer. Before issuing a formal notice and demand to furnish information, the auditor will exercise discretion in a reasonable manner that is appropriate under the relevant circumstances related to that particular audit. In addition, subpoenas may be issued as authorized by Government Code section 15613 to obtain relevant information.

3. A formal notice and demand to furnish information may be issued upon the taxpayer's failure to comply with an initial request and second request for any item of information.

(D) Photocopying. The Board of Equalization may require either the submission of relevant photocopied documents, or that relevant information is made available for photocopying, scanning or other electronic reproduction at a specified time and place for the purposes of administering and verifying compliance with the tax laws. Photocopying is a benefit to both the Board of Equalization and the taxpayer as the photocopy provides objective evidence supporting an issue and allows for expediting the audit.

(E) Audit Conference. Conferences should be held throughout the audit to review the status of IDRs or to discuss proposed adjustments and to ensure that the audit is on track to finish within the estimated completion time discussed during the opening conference.

(F) Audit Issue Presentation Sheet (AIPS). An Audit Issue Presentation Sheet (AIPS) should be used during the course of the audit as soon as the issue is completed to inform the taxpayer of proposed audit adjustments. If an AIPS is not provided, the taxpayer or the taxpayer's representative may request one. An AIPS provides the facts, law, analysis, and the auditor's tentative conclusion concerning a specific issue. The taxpayer will be asked to provide a response confirming or denying the correctness of the factual description of the issue and will be provided an opportunity to provide additional facts and documents or other authority to rebut the auditor's conclusion within a period not to exceed 30 days from the date the AIPS was hand delivered to the taxpayer, or the taxpayer's representative by the auditor or the date mailed by the auditor or as otherwise provided for in subsection (a)(6)(A) of this regulation.

(G) Exit Conference. Items discussed during the exit conference will generally include an explanation of the audit adjustments, the audit schedules, the review process, prepaying a liability, and appeal procedures.

(H) Audit Report. At the close of an audit, the auditor will provide the taxpayer with the audit report. The audit report and audit working papers will explain the facts relied on, relevant law, and analysis and conclusions on all audit adjusted issues.

1. All audit schedules will be provided with the audit report.

2. The taxpayer or the taxpayer's representative will be provided an opportunity to respond to the audit report within a period not to exceed 30 days from the date the position letter was hand delivered to the taxpayer, or the taxpayer's representative by the auditor or the date mailed by the auditor or as otherwise provided for in subsection (a)(6)(A) of this regulation.

3. If the taxpayer or the taxpayer's representative responds to the audit report with additional information for the auditor to consider, the auditor may issue a revised audit report to take into account the additional information.

(c) The audit results are subject to additional review by Board of Equalization staff to ensure that the audit recommendations are consistent with Board of Equalization policies, practices, and procedures. Adjustments to the audit recommendation made by review staff will be communicated to the taxpayer or the taxpayer's representative by the auditor.